EX PARTE OR LATE FILED

Bruce K. Cox
Government Affairs Director

Suite 1000
1120 20th Street, N.W.
Washington, DC 20036
202 457-3686
FAX 202 457-2545
ATTMAIL !bkcox

DOCKET FILE COPY ORIGINAL

March 10, 1995

William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

RECEIVED
MAR 10 1995
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Re: Price Cap Performance Review for Local Exchange Carriers -- CC Docket No. 94-1 (Ex parte Filing)

Dear Sir:

On behalf of AT&T Corp. ("AT&T"), I am submitting for filing in the above-referenced proceeding this response to the February 9, 1995 ex parte filing in this docket by the United States Telephone Association ("USTA"). USTA's filing contends that AT&T's direct model for determining the price cap LECs' productivity offset "has serious theoretical and mathematical flaws" that preclude reliance on the model's outputs. As shown below, there is no basis for any of USTA's claims.

As a threshold matter, USTA erroneously asserts (p. 2) that AT&T's direct model is somehow flawed because it "does not measure productivity." The short answer to this ominous-sounding accusation is that the direct model is not intended to measure "productivity" as USTA defines that term (i.e., as total factor productivity, or "TFP") and AT&T has never claimed otherwise. However, AT&T's model accurately measures the appropriate value of the productivity offset (the "X" factor in the LEC price cap equation), using the principles underlying the Commission's LEC Price Cap rules. AT&T's model is therefore "flawed," as USTA claims, to the same extent as the LEC Price Cap plan prescribed by the Commission.

USTA next points out that many price cap LECs have Actual Price Indices ("APIs") below those carriers' price ceilings, and claims (p. 3) that the direct model's calculations of the LECs' earnings are "arbitrarily inflated" because those figures include amounts by which

No. of Copies rec'd 0+2
List A B C D E

those carriers priced below their price caps.[1] Again, this misstates the workings of AT&T's model. The direct model derives a test Price Cap Index ("PCI") -- and, hence, a test X value -- using a ratio of actual and test revenues. In order to develop that ratio, the model must necessarily derive the correct amount of revenues that would have been produced at the LECs' actual PCI, which includes the amount by which those carriers were "under cap."

USTA's objection to the inclusion of the "under cap" test revenues also ignores the fact that the same analysis -- and the same outcome -- can be achieved by instead using a ratio of the actual and test API values. Because the direct model's test assumption is that pricing will be at the cap, (i.e., API(test)=PCI(test)), the test revenue amount equals actual revenue times (PCI(test)/API(actual). This is mathematically equivalent to the results produced by the direct model.

USTA also claims (p. 3) that AT&T erroneously relied on LEC Tariff Review Plans ("TRPs") that did not include either GNP-PI or productivity adjustments to compute LEC productivity for the period January-June 1991, and that the calculated productivity offset is overstated.[2] USTA overlooks the fact that, had the GNP-

---

[1] USTA also claims (id.) that the direct model "ignores the effects of price elasticity" in assuming that LECs could increase rates to their price ceilings without repressing demand. As AT&T explained at the time it submitted the model to the Commission, although elasticity is not included in the model assumptions, the effect of the test "X" value is to drive revenues (and therefore prices) downwards, thereby producing demand stimulation. Because LEC access prices are presumptively above marginal cost, such demand stimulation would result in higher LEC profitability and require an even higher calculated "X" value to produce the objective rate of return.

[2] USTA also mistakenly claims (id.) that AT&T's reliance on data for the period July 1993-December 1993 resulted in an overstatement of its productivity calculation. This assertion is incorrect. With the exception of the period January-June 1991, AT&T's direct model filed with the Commission in November 1994 is based on data for full price cap years (e.g., July 1993-June 1994). In all events, moreover, use of the half-year data for the July-December 1993 period would produce no significant difference in the model's calculated X value.

PI and productivity offset for this period were set at zero, the calculated X factor developed by the direct model would have been even higher.[3] With both GNP-PI and X set to zero, test revenues and return for the period would increase; to offset these higher amounts, reductions in revenues and returns for subsequent periods would be required. Such a result could only be achieved by a higher calculated value for the X factor.

USTA again claims (id.) that the direct model "further overstates LEC productivity results" by erroneously equating those carriers' three year average rate of return with the "single year productivity impact" of the X factor. According to USTA, this improperly "ignores the compounding effect of the productivity offset". Once again, this criticism of the AT&T direct model is baseless. USTA previously raised this claim regarding AT&T's "simple model" (which is not in issue here), and asserted that the same alleged deficiency must also carry over into the direct model. However, AT&T has demonstrated that USTA's assumption is mistaken, and that its critique has no relevance to the results of the direct model.[4]

Finally, USTA asserts (p. 4) that AT&T "may have double counted" in its direct model exogenous cost reductions totaling $1 billion that were already included in the LECs' price cap indices. This claim is likewise incorrect and a further reflection of USTA's serious misunderstanding of the direct model's operation. The test PCI in that model is completely independent of the LECs' actual PCIs. Accordingly, it is beside the point that the exogenous cost changes cited by USTA "have already been included" in the latter indices.

---

[3] In like manner, if the test X for the interexchange basket had been set at a value .3 percent lower than that for the other baskets, that would have necessitated a higher X value for the remaining price cap baskets.

[4] See Ex parte Letter dated September 1, 1994 from Bruce Cox, AT&T, to William F. Caton, FCC with attachment "Productivity Issues," at p. 4. USTA has also failed to take account of a feature of the direct model as submitted in November 1994 which allows the time value of money to be included in the calculation of the X factor. Contrary to USTA's claim, when the time value of money is included in that computation there is no significant impact on the calculated X result.

In addition to these demonstrably baseless criticisms of AT&T's direct model, USTA's February 9 ex parte attempts (at pp. 4-5) to rebut AT&T's prior showings regarding the many serious deficiencies in the "Christensen study" filed by USTA with the Commission on January 20.[5] Surprisingly, in light of its critique of alleged data deficiencies in AT&T's direct model, USTA completely fails to acknowledge that the Christensen study is based almost entirely on data regarding those carriers' purported performance prior to the advent of LEC price caps. In contrast to the AT&T direct model, which covers the LECs' earnings performance from the inception of price caps on January 1, 1991 through July 31, 1994, the Christensen study is based on data for just eighteen months of those carriers' operations under incentive regulation (i.e., the second half of 1991 and 1992).[6] The remaining six data points in the Christensen study (the years 1985 through 1990) purportedly measure LEC productivity under rate of return regulation. At most, that portion of USTA's analysis could only provide baseline information for comparison to the LECs' achieved productivity under price caps.

The Christensen study is therefore largely beside the point in the context of the present proceeding, whose express purpose is to determine the LECs' performance under incentive regulation. Specifically, in the LEC Price Cap Order the Commission stated that the purpose of its performance review would be "to evaluate the [LEC price cap] system as

---

[5] See Letter dated January 20, 1995 from Mary McDermott, USTA, to William F. Caton, FCC, with attachment "Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation, 1993 Update" by Laurits R. Christensen, Philip E. Schoech, and Mark E. Meitzen ("Christensen study").

[6] See Christensen study, Table 1. Although the Christensen study was submitted for the avowed purpose of updating an earlier analysis by those same consultants by incorporating 1993 data, those new data in fact have no impact on the study because the 1993 U.S. economy TFP growth rate (which is required to calculate the TFP growth differential) is not available.

implemented, and LEC performance under it."[7] Moreover, the Commission deliberately set the performance review to commence three years after the inception of LEC price cap regulation because it recognized that "the review period must be long enough to allow the effects of incentive regulation to unfold before a scheduled evaluation."[8] And its decision pointed out that collection of data through ARMIS on the LECs' achieved earnings and other variables would permit the Commission to "compare the LECs' performance under caps with their performance under rate of return regulation."[9]

In sum, this proceeding is intended as "a comprehensive examination of the effects of price cap regulation" on the LECs' operations -- including, in particular, the impact of this regulatory regime on those carriers' productivity.[10] Measured against that standard, the Christensen study falls short as a useful tool for analysis. At best, it provides only narrowly limited insight about the impact of incentive regulation on the LECs' recent productivity, which is the focus of the Commission's performance review.

---

[7] Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786, 6834 (1990)(¶ 385)(emphasis supplied).

[8] Id. (¶ 388).

[9] Id. (¶ 389).

[10] See Price Cap Performance Review for Local Exchange Carriers, 9 FCC Rcd 1687, 1688 (¶ 9); see also Policy and Rules for Rates of Dominant Carriers, 4 FCC Rcd 2783, 3285 (¶ 861).

Two copies of this ex parte filing are being submitted in accordance with Section 1.1206 of the Commission's Rules. Please include this filing in the public record of these proceedings.

Respectfully submitted,

Bruce K. Cox

cc: Lauren J. Belvin
Karen Brinkmann
James L. Casserly
James R. Coltharp
Michael Katz
A. Richard Metzger
David Nall
Keith Townsend
Mark Uretsky
Kathleen M. H. Wallman
Richard Welch